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FED SHADOW

Of Two Minds

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Bernanke used to think low inflation was consistent with steady growth -- now it seems he can't decide between them.

Update to strategic view
US BONDS: The Fed will only cut rates under circumstances highly unlikely to actually occur. Long-term Treasuries, currently priced only for a single rate cut this year, will still be disappointed as inflation pressure rises and the economy stays reasonably robust. Yields will move higher from here as the last of the rate cut expectations are abandoned.
[see Investment Strategy Dashboard]

The Fed recognizes that inflation is a clear and present threat, but is taking the position that this is not the time to do anything about it. That's the unavoidable conclusion that emerges from the minutes of the March 21 FOMC meeting released yesterday. In the statement following that meeting, the Fed removed reference to the potential for "additional firming" while at the same time warning that inflation was the "predominant policy concern." The minutes of this meeting are unusually revealing in fleshing out the policymakers' reasoning, but serve mainly to underscore the heightened risk of inflationary policy error as the Fed pursues its of-two-minds approach.

Even as the Fed outlined in the minutes what it saw as somewhat greater downside risks to growth, arising primarily from the ongoing housing correction and recent sluggishness in business investment, it asserted that these were unlikely to keep the economy from expanding at a "pace close to or modestly below the economy's trend growth rate." The Fed acknowledged, though, that "the prevailing level of inflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path." While most members of the panel "continued to expect that core inflation would slow gradually," the minutes say, recent inflation readings had "increased the odds that inflation would fail to moderate as expected; that risk remained the Committee's predominant concern."

Apparently not predominant enough. While the "Committee agreed that further policy firming might prove necessary to foster lower inflation," the policy record says, "in light of the increased uncertainty about the outlook for both growth and inflation, the Committee also agreed that the statement should no longer cite only the possibility of further firming." In other words, even while noting inflation risk remains at high levels, the Fed wanted it known it was not ruling out the possibility that it could be compelled to cut rates if such action seems warranted by weaker economic conditions. While we view such an eventuality as unlikely, the fact is significant inflationary consequences have already arisen from the central bank's long-running

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accommodation. The vacillation now being exhibited offers little confidence that policy will be restored to an equilibrium posture soon enough to staunch further erosion in the purchasing power of the unit of account.

For all that, there is reason to question whether, just three weeks since the FOMC meeting, a non-trivial shift in thinking might already be underway. A major catalyst for such a shift could have been provided by last Friday's employment report, which showed a well-above-expectations gain of 180,000 in March nonfarm payrolls and another downtick in the unemployment rate to 4.4%. Against the backdrop of nearly nonstop angst regarding the health of this expansion, the labor market continues to post gains refuting the notion that a significant slowdown is at hand, with an average monthly addition to payrolls of some 170,000 since last December. For the Fed, not only would such continued robust job growth diminish whatever worries it may have about downside risks to growth, it would at the same time tend to reinforce its concerns about what such high rates of "resource utilization" imply for the inflation outlook. In particular, under the Fed's "output gap" framework, the downtrend in unemployment -- which was at 4.8% last July -- suggests that the economy's available slack is steadily being absorbed, even at somewhat slower growth rates. It could well be that a real GDP growth rate of 2.5% to 3% under these circumstances would be enough to indicate to the Fed that further rate hiking action is required against the specter of "excess aggregate demand." From our perspective, such a demand management paradigm is an entirely fallacious approach to policymaking. In this environment, however, such a "right thing for the wrong reason" response could be what it takes to get the Fed off the dime and refocused on unfinished business.

In any case, while the Fed's current dithering can certainly be seen as continuing to defer the date of an eventual return to tightening mode, any prospect of a move to rate cutting based on currently observable conditions still seems highly far-fetched. Yet, while in the past few weeks the odds attached to such prospective rate cuts have been cut by about half, fixed income markets remain keyed to expectations in interest rate futures pricing for more than one 25 basis point rate cut by year end, and nearly two cuts by March '08. In the past month, the 10-year Treasury yield, at just below 4.75%, has tacked on about 25 bps in accord with the unwinding of rate cut expectations. But we expect to see yields continue to move higher as the idea of any shift to lower rates comes to be seen as increasingly unrealistic.

BOTTOM LINE: The Bernanke-led Fed's ambivalence toward its overriding objective of ensuring price stability has never been more clear. The minutes of the March 21 meeting were a revealing demonstration of its conflicted perspective on how best to balance its so-called "dual mandates" of maintaining healthy growth and low inflation. While Bernanke came into this office professing that, properly understood, such objectives were not in conflict -- that low and stable inflation was essential to sustainable growth -- his confidence in that formulation seems already to have faded away. It's now an unavoidable fact that a period of significantly higher risk of inflationary policy error is at hand.